Non-Shareholder Contributions to Capital: An Update on the IRS Scrutiny of Section 118

Tax Controversy Alert
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The ability to exclude various receipts from gross income as non-shareholder contributions to capital under section 118(a) of the Internal Revenue Code remains a source of considerable controversy. In recent weeks, the Internal Revenue Service has issued additional guidance of which clients that have or are considering applying the principles of section 118 should be aware in assessing their potential exposure to an IRS challenge.

Changes in Accounting Method

On June 4, 2008, the IRS announced it would not follow the Tax Court’s 1992 decision in Saline Sewer Co. v. Commissioner, T.C. Memo 1992-236. In Saline Sewer, the Tax Court held that where a taxpayer previously had concluded incorrectly that customer connection fees were excluible from gross income under section 118(a), the taxpayer’s beginning to include those payments in gross income is not a change in accounting method requiring IRS consent. Instead, the Tax Court found that because section 118(a) determines whether an amount is includible in gross income rather than when it is includible, the application of section 118(a) results in a permanent difference in the taxpayer’s lifetime income. As such, the correction is not a change in accounting method. The Tax Court rejected the IRS’s argument that because applying section 118(a) also affected the depreciable basis in property acquired with the funds, an exclusion of income under section 118(a) decreased the taxpayer’s allowable depreciation in future years (and vice versa), such that a difference in the timing of the taxpayer’s lifetime income was in fact implicated.

In Rev. Rul. 2008-30, 2008-25 I.R.B. 1, the IRS adhered to its Saline Sewer position. In the IRS’s view, analyzing the effect of section 118(a) on the taxpayer’s lifetime income must consider the effect both on income and deductions. The IRS believes the Saline Sewer court erred in analyzing the receipt of customer connection fees independently from the effect on depreciable basis of the improvements constructed with those fees. In the IRS’s view, the analysis instead must consider the effect of the combined changes in income, basis, and depreciation on the taxpayer’s lifetime income. Rev. Rul. 2008-30 thus announces that the IRS will not follow the Tax Court’s decision in Saline Sewer or the federal district court’s decision in Florida Progress Corp. v. United States, 156 F. Supp.2d 1265 (M.D. Fla. 1999).

In considering the impact of Rev. Rul. 2008-30, taxpayers should keep in mind that while courts confer tremendous deference upon the IRS in applying section 446, that discretion is not unlimited. Two courts have already considered, and rejected, the IRS position.

Tax Incentives

On May 23, 2008, the IRS issued a coordinated issue paper (LMSB-04-0408-023) discussing the application of section 118(a) to state and local location tax incentives. The IRS expressed concern that some corporate taxpayers have taken the position that a location tax incentive in the form of a tax abatement is a taxable receipt under section 61 of the Code, followed by the recipient’s use of that receipt to discharge its state or local tax liability. The taxpayer claims a federal tax deduction for the state or local taxes treated as having been paid with the receipt. Under this approach, the taxpayer also takes the position that the receipt is excluded from the corporation’s income as a non-shareholder contribution to capital under section 118(a), with a corresponding reduction in the basis of property under section 362 equal to the capital contribution.

The IRS has announced that, in its view, the tax abatement is not a taxable receipt for purposes of section 61. Instead, the state or
local tax benefit is treated for federal tax purposes as a reduction or potential reduction in the taxpayer’s state or local tax liability, and is neither included in income nor allowable as a deduction.

Based on its conclusion that the tax abatement is not a taxable receipt, the IRS likewise concludes that the tax benefit is not “money or property contributed to a corporation” to which section 118(a) may be applicable. This renders the basis reduction provisions of section 362 moot for this purpose as well. Further, just as there has been no receipt for purposes of section 61, neither has that amount been used to discharge a tax liability for which a deduction would be allowable under section 164. Instead, in the IRS’s view, no such tax liability arose or was discharged. Finally, the IRS concludes that even if the tax incentive were treated as an item of gross income, the receipt would not be excludible from income as a non-shareholder contribution to capital. Instead, the IRS concludes that the receipt would not satisfy the criteria established by the Supreme Court in United States v. Chicago, Burlington & Quincy R.R. Co., 412 U.S. 401 (1973) because, among other things, it could be used to pay dividends, operating expenses, or for any other purpose.

Income Subsidies vs. Capital Contributions

In a coordinated issue paper dated April 8, 2008 (LMSB-04-0308-019), the IRS takes the position that bioenergy program (“BEP”) payments received from the U.S. Department of Agriculture may not be excluded from gross income as non-shareholder contributions to capital. Instead, the IRS concludes that the BEP payments are intended to compensate the taxpayer for operating costs incurred as a result of purchases of commodities in the taxpayer’s bioenergy production process. Rather than being a permanent addition to the taxpayer’s working capital structure, the IRS concludes that the payments are income subsidies. The IRS looks to its recent victory in United States v. Coastal Utilities, Inc., 483 F. Supp.2d 1232 (S.D. Ga. 2007), aff’d 514 F.3d 1184 (11th Cir. 2008) (refusing to apply section 118(a) to universal service fund payments received by a telecommunications provider) as support.

Next Steps

Rev. Rul. 2008-30 and the coordinated issue papers reflect the recent pattern of controversy regarding the application of section 118(a) in a number of contexts. As discussed in an earlier Miller & Chevalier Tax Controversy Alert, the IRS perceives a recent pattern of abusive applications of section 118(a) and has reacted strongly. The IRS has designated “section 118 abuse” as a Tier 1 issue under its Industry Issue Focus initiative. Even taxpayers who previously have not encountered issues with respect to their application of section 118(a) to various payments may find those positions coming under scrutiny. Taxpayers should consider reexamining their current tax positions under section 118(a), objectively assessing the strength of those positions, and where necessary, taking corrective actions before the IRS has an opportunity to raise the issue on examination.

Miller & Chevalier anticipates conducting a complimentary teleconference in the near future on the current audit climate with respect to the application of section 118 and steps that taxpayers should consider in assessing the strength of their current positions and preparing for potential IRS scrutiny of those positions. Further information regarding that teleconference will be forthcoming. In the meantime, please contact any of the following individuals for more information regarding the current issues surrounding section 118(a).

For further information, please contact any of the following lawyers:

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